

CITY OF SAN JOSÉ

**DEVELOPMENT OF STRATEGIES TO
ADDRESS THE CITY'S
GENERAL FUND STRUCTURAL BUDGET DEFICIT**

January 2008



MANAGEMENT PARTNERS
INCORPORATED



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January 4, 2008

Ms. Debra Figone
City Manager
City of San José
200 E. Santa Clara Street
San José, CA 95113

Dear Ms. Figone:

Enclosed is the project report from Management Partners' work to develop strategies to address the City's General Fund structural budget deficit.

The array of choices available to the City is extensive and will require more discussion and analysis with the San José community. Determining actions from among these choices will generally not be easy, because the government is extremely complex and has had to cope with annual budget deficits for the last six years. Nevertheless, there are a number of different strategies the City can use to address the structural budget deficit outlined in this report. The report also suggests some budget principles that will help the City avoid future shortfalls.

We would like to thank you, the City Council, City appointees, senior management staff, the Budget Shortfall Advisory Group and City staff who worked with us on this important project.

Sincerely,

Gerald E. Newfarmer
President and CEO

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EXECUTIVE SUMMARY

In February 2007 the Mayor, City Council, City Appointees and Senior Management Staff participated in a strategic planning session to set City objectives for the next three years. One of the five identified three years goals is to eliminate the structural budget deficit. The definition of this objective set in motion the development of this report. The Mayor also convened a panel of citizens with experience in local government services to serve as his Budget Shortfall Advisory Group (BSAG). This panel began meeting in October of 2007.

The City had faced persistent deficits in its General Fund dating from what is commonly referred to as the “dot-com bust,” the recession of 2001. The budget deficits continued even though each year the City had taken the revenue increase or expenditure reduction steps necessary to bring the budget into balance prior to adoption.

The City Manager's 2007-2008 budget message (May 2007) noted that the proposed fiscal year 2007–2008 budget assumed funding most of the current year shortfall with current year dollars, but that there were unmet needs in addition to the persistent General Fund structural deficit. Although these needs had not been incorporated into an adopted budget, they are of concern to City leaders, since the long-term health of the City requires that they be addressed. Unmet needs include significant infrastructure maintenance requirements, commitments to health insurance for retirees, vehicle replacement, and the additional service delivery capacity required to serve a continually growing resident population.

Recognizing that the solution to this persistent problem required that difficult political choices be made, the City defined a process through which a qualified consulting firm would work with staff, the BSAG and other stakeholders to provide independent advice about possible solutions. This process to develop the family of strategies required to eliminate the structural deficit (totaling \$137 million) included a considerable amount of consultation with a Budget Shortfall Advisory Group established by the Mayor, and with the City Manager's General Fund Structural Deficit Task Force. In addition, it was determined that five focus group sessions should be held with broad-based stakeholder representation drawn from the community and City employees as well as an employee electronic survey should be deployed. Participation in the focus groups was limited to insure that a diverse range of interests could

be represented and to make sure that participants had the ability to meaningfully discuss the issues.

Management Partners, a national consulting firm specializing in local government with offices in San José and Cincinnati, was hired to facilitate these deliberations, gather input from the various internal and external stakeholders about potential strategies, conduct data analysis including peer benchmarking comparisons, and review best practices in high-performing cities nationwide. The recommendations draw upon not only the City of San José's experience, but on professional management practices followed in other large and complex local government settings. The goal of this review was to identify strategies that would eliminate the General Fund structural deficit over the next three years.

Throughout the strategy development process, we sought the answers to four basic questions:

1. What are the priorities and suggestions from the stakeholder groups?
2. Is the City "at market" with peer jurisdictions in terms of revenues, expenditures and other key variables?
3. Are there good ideas being used in other jurisdictions that can be replicated in San José?
4. Can a strategy have significant impact on the deficit within a three-year timeframe?

Through this process, over 320 suggested strategies were identified, and screened against more refined qualification/disqualification criteria (see Attachment A). The criteria used to qualify a possible strategy for consideration were:

1. Preliminary benchmarking information shows that San José is below market (revenues) or above market (expenditures).
2. Strategy is being used in a best practice jurisdiction or a peer jurisdiction.
3. Prior work by budget office or other City department has made a convincing argument for change.
4. Practice is out of alignment with current City objectives or planning.

The criteria used for disqualifying a possible strategy for consideration were:

1. Strategy cannot be effectively implemented in the three-year time frame.
2. Strategy would not reduce deficit or if it does would have greater longer run costs.
3. Strategy is not consistent with current Council three-year goals.
4. Strategy would have a limited impact, and cannot logically be combined with other similar strategies.

A total of 320 strategies were deemed viable and of these, top priority strategies are proposed for consideration by policy makers. Many of these top priority strategies incorporate a number of individual strategy

suggestions within the same general topic area. These strategies could have a positive fiscal impact of \$115 million (low end estimate) and \$218 million on the high end. Revenue and cost estimates for strategies were developed from existing information and will need further analysis prior to final implementation. By pursuing an appropriate combination of these strategies, the City has the opportunity to eliminate its General Fund structural deficit of \$137 million in three years.

Because the City has continually faced and taken steps to deal with budget deficits over the past six years there are few, if any, easy choices.

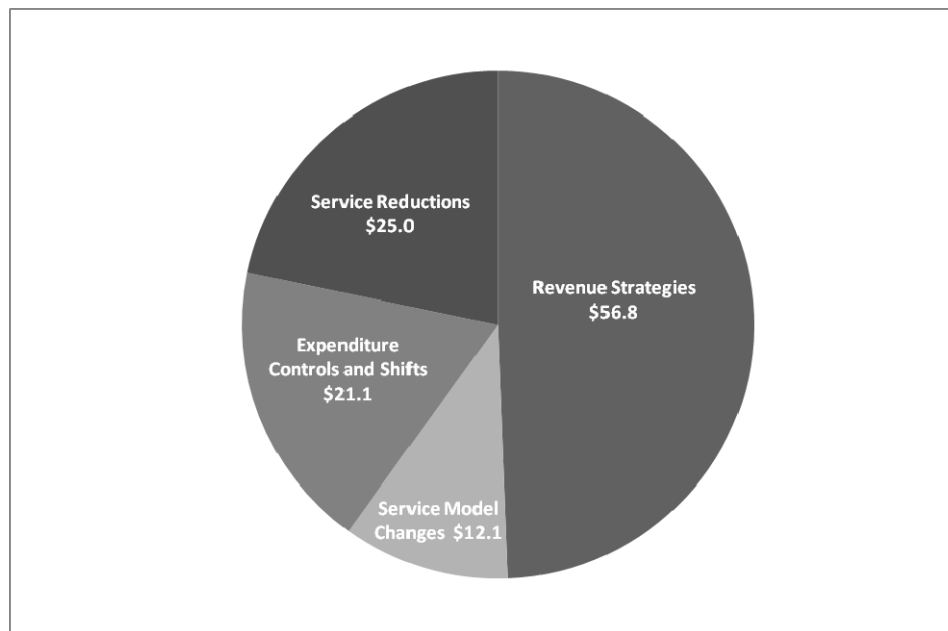
The strategies we identified as meeting the basic qualification criteria are grouped into the following categories.

- Revenue Strategies
- Service Delivery Model Changes
- Expenditure Controls and Shifts
- Service Reductions

With regard to the Service Reductions category, it was determined that the best way to proceed in defining viable options would be to tap into the deep expertise of City staff during the regular budget process. Therefore, as part of the annual budget process for 2008-09, City Service Area and departmental budget reduction strategies will be developed with employee engagement. The City Manager will bring forward ongoing service reduction or elimination recommendations in the Proposed Operating Budget for City Council consideration as part of the budget review process in May.

The aggregate budget deficit reduction strategies developed under each category are shown in Figure 1 below.

**FIGURE 1: RELATIVE CONTRIBUTION OF BUDGET REDUCTIONS STRATEGIES
AT LOW RANGE ESTIMATE OF \$115 MILLION**



Generally, strategies in the categories of Service Delivery Model Changes, Expenditure Controls and Shifts, and Service Reductions all involve changes in the way the City currently does business. Many of these strategies will also require the “meet and confer” process with employee groups. As noted many of these changes would not be easy to implement, largely because the options available to the City have gotten progressively harder in the years since 2001. Together, these strategies account for about 51% of the total dollars identified from potential solutions. Revenue Strategies contribute about 49% of identified solutions. These strategies generally do not require changes in the way the City does business. As part of the benchmarking analysis (discussed later in this report) we found that San José lags peers (particularly other large cities in the Bay Area) in several areas of revenue generation. However, it should be kept in mind that implementation of many of these revenue enhancements will require voter approval, and such approval is always a difficult task.

The strategies and their contribution to solving the General Fund Structural Budget Deficit are briefly summarized below.

Under the broad heading of Revenue Strategies this report outlines the following strategies in priority order for consideration. Overall priorities were developed by the City Manager's Structural Budget Deficit Reduction Task Force, informed by input from various stakeholder group meetings.

1. **Extend the Emergency Communication System Support Fee (\$23.4 million).** The fee offsets 88% of the costs associated with operation of the 911 dispatch center. The fee is slated to sunset in 2009 and the potential loss of this revenue represents a significant part of the structural deficit.
2. **Utilize Financing Strategies which have Positive Net Present Value (\$1.7 to \$6.1 million).** The City has certain limited opportunities to take advantage of its superior credit rating, well funded pension funds and overall positive fiscal situation to generate current revenues, without simply shifting the problem to a later date.
3. **Ensure Current Fees Fully Cover All City Costs (\$2 to \$9 million).** Benchmarking and San José's own analysis show that some fees do not fully cover costs.
4. **Restructure Business Tax Rates to Modernize and Reflect Current Business Profile (\$6.3 to \$15 million).** The business tax was last updated in the 1980s. Since then, the nature of business within the City has changed considerably and the tax rates have been eroded by inflation. Updating the business tax could result in new revenues for the City between \$6.3 to 15.0 million, depending on how aggressively this strategy is pursued.
5. **Modernize Utility Users Tax and Consider Bringing Rate into Alignment with other Large Cities having this Tax (\$7.9 to \$39.6 million).** San José could recoup increased revenues of \$3.6 million for every 0.25% increase in its Utility Users Tax rate. Increasing the tax rate from 5% to the state average for cities with a utility tax (5.5%) would represent an increase of \$7.9 million. The tax could also be modernized to better withstand potential legal challenge and to broaden somewhat the utility base it is applied against. Raising the tax to the average for larger cities (7.5%) would yield approximately \$39.6 million based on the existing tax structure.
6. **Implement Citywide Lighting and Landscape Districts or Other Proposition 218 "Property Related" Fees (\$2.5 to \$11 million).** San José can more aggressively pursue assessment and related revenues as do many other cities. Net benefit to the General Fund would be approximately \$11 million from a \$50 per parcel annual fee. The benefit to the General Fund for charges to the water utility for City services would be approximately \$2.5 million per year.
7. **Levy Parcel Tax or Sales Tax for Public Safety or Other Services (\$14 to \$38 million).** San Jose's sales tax rate is currently below average for the Bay Area and the City lacks

parcel taxes that have become reasonably common in other cities. A parcel tax of \$53 per parcel in San José would generate \$14 million in new revenues annually. Raising the City's sales tax by ¼ cent would raise approximately \$37 million in annual revenue. Many cities in California have approved a variety of parcel taxes and increases to the sales tax to fund services.

8. **Increase Transient Occupancy Tax to Market and Shift to General Fund (\$4.5 to \$11.3 million).** A 2% increase in the Transient Occupancy Tax from 10% to 12% would raise \$4.5 million for the General Fund if it were all placed there. The General Fund could see an additional \$6.75 million if half of the existing 6% that is allocated for special purposes is transferred back into the General Fund, although those funds have been allocated to valued community services which constituents would not like discontinued. Downtown hotels have already developed a proposal to voluntarily increase the TOT and use the increased revenues to expand the Convention Center.

Under the heading of **Service Delivery Model Changes**, this report outlines the following strategies in priority order for consideration.

1. **Formalize and Implement a Rigorous Asset Management Program (\$3.3 to \$5 million).** This should generate at least \$15 to \$25 million on a one-time basis with additional annual revenues from eliminating lease subsidies and from the present annual value of revenues generated from one-time monies ranging from \$3.3 to \$5 million.
2. **Combine Redevelopment and City Corporate Support Functions and Shift Economic Development Costs to Maximum Extent Possible (\$5.4 million).** If the City provided human resources, finance and information services to the Redevelopment Agency, as much as \$5.4 million in net revenue could be realized. This is because the marginal costs of providing these services on a centralized basis is generally less than providing them on a parallel stand-alone basis.
3. **Revise Competition Policy, Implement Managed Competition for Service Delivery, and Optimize Work Processes (\$8 to \$13.3 million).** Many cities have derived meaningful cost savings by comparing City service delivery approaches with the alternative of contracting with the private sector. City employees often have been able to substantially improve internal service delivery efficiency when a fair competitive process is introduced. Another similar approach is to systematically "optimize" city service delivery by subjecting existing service approaches to a rigorous analysis aimed at eliminating no or low value added procedures. Because these approaches are not a panacea we

have developed conservative savings estimates developed from comparisons with other large cities.

4. **Increase Use of Civilian Positions in Police and Fire (\$0.5 to \$1.5 million).** Sworn police officers are an extremely important, scarce and expensive resource. Cities are taking steps to maximize the productivity of each such position. One approach is to have less expensive non-sworn personnel support perform work currently done by sworn officers. An incremental implementation of civilianizing certain tasks in police and fire could save as much as \$1.5 million over the next three years, phased in with department retirements. Much larger savings over the next 10 to 20 years would be expected compared with the existing staffing pattern.
5. **Eliminate Binding Interest Arbitration (Future Cost Avoidance).** The current approach to binding interest arbitration for public safety services used in the City does not appear to encourage collaboration and problem solving. Instead it results in an adversarial process between the City and employee groups, rather than a dialogue about how best to operate in a world of limited resources. The process has resulted in wage and benefit decisions that have been greater than the growth in the City's basic revenue sources. Given the fiscal realities facing the City perhaps now is the time when some common ground can be found so that collaborative and innovative approaches are encouraged rather than discouraged. This would require a change in the City Charter by voter approval.
6. **Modify Minimum Fire Staffing Policies Where Appropriate Based on Fire Strategic Plan (Dollar impact to be determined).** As in the Police Department, each sworn position in the Fire Department is important and expensive. The Fire Department is currently completing an update to their Strategic Plan. The Fire Strategic Plan coming forward in early 2008 should be used as an opportunity to consider how to deploy existing staff more effectively to increase productivity and minimize continuing expenditure growth. This plan is expected to test alternative service delivery methods which may impact current staffing approaches.
7. **Implement an Employee Suggestion and Process Streamlining Program (Up to \$1 million).** Employee empowerment programs are a mainstay for developing more productive approaches in many industries and can be successfully utilized in the public sector. The strategy ideas generated by City employees as part of this process are impressive in scope, and a valuable starting point for a leading edge program in the City of San José. Experience has shown that a good program in a setting such as San José can generate

up to \$1 million in annual savings and raise employee morale, while building a culture focused on continuous improvement.

Under the heading of Expenditure Controls and Shifts, this report outlines several strategies for consideration in priority order. Since employee compensation and benefit costs constitute approximately two-thirds of General Fund expenditures, creating ways to reduce the rate of increases in such costs are a major focus of strategies in this group.

1. **Shift Healthy Neighborhood Venture Fund Funding to General Fund (\$5 to \$9 million).** A shift of these funds away from the current recipients would likely result in objections. However, in doing so, the City could see new revenues of \$5 to \$9 million per year by shifting the Healthy Neighborhoods Venture Fund funding back to the General Fund. Competition for monies in the General Fund is a strong and beneficial discipline.
2. **Reduce Worker's Compensation, Disability, and Overtime Costs (\$3 to \$4.2 million).** A variety of relatively modest strategies used in other settings can Cost savings from a variety of strategies can result in expenditure savings of from \$3.3 to \$4.2 million annually.
3. **Shift Construction and Conveyance Tax Funding from Capital Projects to Operating and Maintenance Costs (\$6 to \$12 million).** This funding source should be realigned so that it is used to reduce the General Fund structural deficit to the maximum extent practicable, and that it not be used to build more facilities that increase the City's costs until the structural deficit is cured.
4. **Reduce the Rate of Increase in Employee Salary and Benefit Costs (\$6.6 to \$10 million).** Employees are the City's most valuable resource, and also the largest source of expenditures. Personnel costs have been running ahead of growth in the underlying economy, and growth in basic City revenue sources. Therefore some consideration needs to be given to controlling or slowing this area of expense. The following strategies, of which many have meet and confer implications, address this objective in a variety of ways.
 - a. **Increase Time to Reach Maximum Compensation (\$1.9 million).** Reducing the rate at which employees reach the top step can save \$1.9 million annually for the General Fund.
 - b. **Reduce Entry Level Compensation for Positions for which the City Receives Many Qualified Applicants (\$0.7 to \$1.7 million).** The City must remain a

competitive employer. However the market is different for various jobs. In some limited cases the City receives many qualified applications for available positions. Reducing the starting salary, or broadening the salary range, for such positions would save the City money and allow good candidates to be recruited because the City is a sought after employer for some (mostly entry level) classifications

c. Implement Health Care Plan Modifications (\$1.2 to \$4.6 million). All businesses are being impacted by soaring health care costs. Most, even in the public sector, are asking that employees share some of these increased costs. It would be reasonable for the City of San José to move to an average level of cost sharing for public employers.

d. Implement Sick Leave Upon Retirement Program Payment Modifications (\$1.8 million). The City has an interest in providing an incentive for employees to appropriately utilize sick leave. In regard to public safety positions, it is arguable that the City is paying more than is necessary to provide such an incentive and is more generous than other public employers

5. Change Prevailing Wage Applications: Eliminate Service Contracts (\$1.2 million). In some cases the City has expanded the coverage of prevailing wage requirements beyond what is specified by state law. Changing this policy would enable the City to do a better job of confirming that prevailing wages are paid as required on covered work and reduce costs. A savings of \$1.2 million in General Fund costs, with higher overall savings to other City funds, could be expected by making certain changes to how prevailing wages are applied to projects.

With regard to Service Reductions, a determination was made to address this facet of solving the structural deficit via the City's annual budget process. As mentioned previously, budget reduction strategies will be developed as part of the annual budget process. The City Manager will bring forward ongoing service reduction or elimination recommendations in the Proposed Operating Budget for City Council consideration as part of the budget review process in May 2008. The target for service reductions is \$25 million per year.

As part of the General Fund structural deficit effort, budget principles were also developed and included in this report for potential adoption by the City Council to serve as a meaningful framework for maintaining the financial discipline crucial to a large organization like the City of San José and to help avoid another structural budget deficit in the future. The

12 recommended principles included for consideration were developed from examining San José's existing budget policies, best practice policies and literature in the public financial management field.

The array of choices available to the Mayor's Budget Advisory Group and the City Council is extensive and reflects substantial research and significant analysis. In its totality, it forms a sound basis for decision makers to chart a feasible course for erasing the structural budget deficit within the next three years. It will take additional dedicated effort and further analysis to fashion an implementation plan that will command the support of the City Council, and, ultimately, the community at large.